

Notice 95-53

Accounting for Lease Strips and Other Stripping Transactions

1995-2 C.B. 334; 1995 IRB LEXIS 339; 1995-44 I.R.B. 21; Notice 95-53

October 30, 1995

[*1] The Internal Revenue Service understands that certain persons have entered into, or may be considering, multiple-party transactions intended to allow one party to realize rental or other income from property or service contracts and to allow another party to report deductions related to that income (for example, depreciation or rental expenses). Transactions of this type are sometimes referred to as "lease strips" or "stripping transactions." This notice discusses certain tax consequences of stripping transactions, both under current law and under regulations to be issued.

The stripping transactions covered by this notice include a variety of forms. For example:

(a) Some typical stripping transactions are effected through a transferred basis transaction. In exchange for cash, notes, or other consideration, one party sells, assigns, or otherwise transfers ("assigns") the right to receive future payments under a lease of tangible property, and treats the amount realized from the assignment as its current income. The party later transfers the property (subject to the lease) in a transaction intended to qualify as a transferred basis transaction, for example, a transaction described [*2] in § 351 of the Internal Revenue Code. The transferee often is not identified until after the transferor has assigned the future payments. Typically, the transferor (or a partner in a partnership that is a transferor) is generally not subject to federal income tax or has available net operating losses, and the equity of the transferee is owned predominantly by persons other than the transferor.

(b) Other stripping transactions may be effected through a transfer of an interest in a partnership (or other pass-through entity). In exchange for cash, notes, or other consideration, the partnership assigns its right to receive future payments under a lease of tangible property and allocates the amount realized from the assignment to its current partners (many of whom are generally not subject to federal income tax or have available net operating losses). The partnership retains the underlying property, and thereafter, there is a transfer or redemption of a partnership interest by one or more partners to whom the partnership allocated the income that it reported from the assignment. The transfer or redemption is structured to avoid a reduction in the basis of partnership property.

(c) Other [*3] variations of stripping transactions might involve, among other things, licenses of intangible property; service contracts; leaseholds or other non-fee interests in property; or prepayment, front-loading, or retention (rather than assignment) of rights to receive future payments.

The Service understands that the parties to stripping transactions generally claim that one party realizes the income from property or services and that another party is entitled to take related depreciation, rental expense, or other deductions. The Service believes, however, that the claimed tax treatment improperly separates income from related deductions and that stripping transactions generally do not produce the tax consequences desired by the parties.

For example, in the case of stripping transactions structured in a manner similar to that described in paragraph (a) above (including transactions with variations like those described in paragraph (c) above), the Service intends to exercise its authority under § 482 to reallocate gross income, deductions, credits, or allowances between the parties as appropriate. Section 482 permits reallocation between two or more organizations owned or controlled directly [*4] or indirectly by the same interests if necessary to clearly reflect income or to

prevent the evasion of taxes. For purposes of § 482, the parties in these stripping transactions generally are "controlled ... by the same interests" because, among other factors, they act in concert with the common goal of arbitrarily shifting income or deductions between the transferor and the transferee. See, e.g., § 1.482-1(i)(4) of the *Income Tax Regulations*. The Service will not apply § 482 to other transactions where not necessary to clearly reflect income or to prevent the evasion of taxes. See *Rev. Rul. 80-198, 1980-2 C.B. 113* (subject to the limitations described therein).

Depending on the facts of a particular case, the Service also may determine that one or more of the following authorities (among others) apply to a stripping transaction: (i) sections 269, 382, 446(b), 701, or 704, and the regulations thereunder; (ii) authorities that recharacterize certain assignments or accelerations of future payments as financings; (iii) assignment-of-income principles; (iv) the business-purpose doctrine; or (v) the substance-over-form doctrines (including the step transaction and sham doctrines). [*5]

In addition, regulations will be issued pursuant to § 7701(l) (and, as appropriate, other sections of the Code) recharacterizing stripping transactions. Under § 7701(l), the Secretary has the authority to prescribe regulations recharacterizing any multiple-party financing arrangement as a transaction directly among two or more of the parties in order to prevent the avoidance of tax. The regulations will be effective with respect to stripping transactions any significant element of which is entered into or undertaken on or after October 13, 1995. For example, the regulations will apply to the stripping transaction described in paragraph (a) above if the property is transferred to the transferee on or after October 13, 1995, even if the rights to receive future rental payments were assigned by the transferor prior to that date.

The Service requests comments with respect to the regulations that will be issued. Written comments should be sent in duplicate to: CC:DOM:FI&P, Room 4300, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. The Service will make these comments available for public inspection.

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